No. 5689.

IN THE

United States
Circuit Court of Appeals,

FOR THE NINTH CIRCUIT.

OCTOBER TERM, 1928.

Alameda Investment Company, a corporation,
Hawley Investment Company, a corporation,
Pacific Nash Motor Company, a corporation,

Appellants,

vs.

John P. McLaughlin, Collector of Internal Revenue for the First District of California,

Appellee.

BRIEF FOR APPELLANTS.

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BRIEF FOR APPELLANTS.

Preliminary Statement.

This is an appeal from a decision and judgment of the United States District Court for the Northern District of California, Southern Division, in favor of appellee, in a suit by appellants for the recovery of certain income taxes alleged in the complaint to have been overpaid by appellants for the calendar year 1922.

The issues involved are briefly stated as follows:

(1) Were the appellants affiliated during the calendar year 1922 within the meaning of section 240(c) of the Revenue Act of 1921, and as such subject to tax for that year on their consolidated net income as a business or economic unit?

(2) Assuming the appellants to be so affiliated for the calendar year 1922, are they entitled to have their tax liability computed as a unit even though they originally filed separate income tax returns for said year 1922?

(3) Are appellants entitled to recover the taxes herein sued for in view of the fact that payment was not made under protest, although suit for the recovery thereof was instituted after the enactment of section 1014 of the Revenue Act of 1924?

The District Court decided each of the above issues adversely to appellants.

The Facts.

During the calendar year 1922, the appellant Hawley Investment Company was a corporation organized under the laws of the state of California, with an authorized and outstanding capital stock of 2,500 shares of the par value of $100.00 each. Stuart S. Hawley throughout the year 1922 individually owned or controlled substantially all the outstanding stock of said corporation. [Rec. pp. 1, 13, 24, 30,]

Throughout the calendar year 1922, the appellant Pacific Nash Motor Company was a corporation organized under the laws of the state of California, with an author-

ized and outstanding capital stock consisting of 3,500 shares of the par value of $100.00 each. [Rec. p. 24.]

Throughout the calendar year 1922, the appellant Hawley Investment Company owned or controlled substantially all of the outstanding stock of Pacific Nash Motor Company. [Rec. p. 30.] Throughout said year said Stuart S. Hawley was in active control of the stock and affairs of appellant Pacific Nash Motor Company through his ownership and control of substantially all the outstanding stock of the Hawley Investment Company. [Rec. p. 30.]

Throughout the calendar year 1922, the appellant Alameda Investment Company was a corporation existing under the laws of the state of California, with an authorized and outstanding capital stock consisting of 2500 shares of the par value of $200.00 a share. [Rec. p. 23.]

Throughout the calendar year 1922, 75 per centum of the outstanding stock of appellant Alameda Investment Company was owned by the appellant Hawley Investment Company, substantially all of the outstanding stock of which was owned or controlled by Stuart S. Hawley. [Opinion of the District Court, Rec. p. 21, Findings of Fact, Rec. p. 24.] Throughout the calendar year 1922, the remaining 25 per centum of the stock of appellant Alameda Investment Company was owned by H. W. Meek Estate, Inc. [Opinion of the Court, Rec. p. 21.]

Throughout the calendar year 1922, H. W. Meek Estate, Inc., was a corporation with an authorized and outstanding stock consisting of 5,000 shares. Throughout the calendar year 1922, said issued and outstanding stock of H. W. Meek Estate, Inc., was owned as follows:

Harriet W. Meek, mother-in-law of Stuart S. Hawley, 2,499 shares.

Harriet Meek Hawley, wife of Stuart S. Hawley, and daughter of Harriet W. Meek, 883-1/3 shares.

Gladys M. Volkmann, daughter of Harriet W. Meek, and sister-in-law of Stuart S. Hawley, 833-1/3 shares.

W. H. Meek, son of Harriet W. Meek, and brother-in-law of Stuart S. Hawley, 833-1/3 shares.

Stuart S. Hawley, 1 share.
[Stipulation of Facts, Rec. p. 30.]

Throughout the calendar year 1922, Harriet W. Meek was a widow, aged 65 years, residing at the Hotel Oakland, Oakland, California. [Rec. p. 32.] Mrs. Meek had absolutely no experience in business matters and prior to her husband's death in 1910 all of her affairs were handled by her husband. Subsequent to his death all of her affairs were handled by her son-in-law, Stuart S. Hawley, under an absolute power of attorney, which power of attorney was in effect throughout the calendar year 1922. [Rec. pp. 33, 35.]

Mrs. Meek never attended stockholders', directors', or other meetings of H. W. Meek Estate, Inc. She never drew a salary from the corporation. She was not certain how much stock, if any, she owned in H. W. Meek Estate, Inc. All of her stock in that corporation was voted, during the calendar year 1922, if at all, by Stuart S. Hawley. [Rec. pp. 33, 34.]

Mrs. Meek maintained checking accounts in various banks in Oakland, California, but she never drew on these accounts. All of her bills were paid by Stuart S.

Hawley by check on her accounts. Stuart S. Hawley had access to her safety deposit box throughout the calendar year 1922. [Rec. p. 34.] During the calendar year 1922 and prior and subsequent thereto, Mrs. Meek never exercised any control over any of her property. All of her affairs were handled by Stuart S. Hawley. [Rec. pp. 36, 37.]

Harriet Meek Hawley, during the calendar year 1922, was the wife of Stuart S. Hawley, living at home. She had practically no business training and all of her affairs during, prior, and subsequent to the calendar year 1922 were handled by her husband, Stuart S. Hawley, under an absolute power of attorney which was given about 1910 and which was in effect throughout the year 1922. [Rec. pp. 54, 55.]

Mrs. Hawley never attended a directors' meeting or a stockholders' meeting of H. W. Meek Estate, Inc., during the calendar year 1922. During the calendar year 1922 Stuart S. Hawley voted the stock of Harriet Meek Hawley in the H. W. Meek Estate, Inc. [Rec. p. 55.]

Throughout the calendar year 1922, Stuart S. Hawley was president of appellant Alameda Investment Company, appellant Hawley Investment Company, appellant Pacific Nash Motor Company, and managing vice-president of H. W. Meek Estate, Inc. Stuart S. Hawley gave a part of his time to and drew a salary from each of these corporations. He also signed all the checks for all four corporations. These four corporations also had a common secretary throughout the calendar year 1922. These four corporations all had the same offices in the Syndicate building, Oakland, California, where all their books and records were kept. [Rec. p. 38.]

The appellant Hawley Investment Company was organized about 1906 and acquired the assets of the Hawley family. Alameda Investment Company was formed in 1909 for the purpose of dealing in real estate. Pacific Nash Motor Company was formed in 1908 for the purpose of engaging in the automobile business. H. W. Meek Estate, Inc., was organized about 1910. [Rec. p. 39.]

Throughout the year 1922 and for many years prior thereto, all of the above four corporations maintained very close business and inter-company relations. For example, Hawley Investment Company was the guarantor and bailee for all the loans and business ventures of appellant Alameda Investment Company and for H. W. Meek Estate, Inc. [Rec. p. 39.]

During the calendar year 1922 and for many years prior thereto, Stuart S. Hawley voted the stock of Harriet W. Meek and Harriet Meek Hawley in the H. W. Meek Estate, Inc. and dictated all the business policies of H. W. Meek Estate, Inc. *Throughout the calendar year 1922, Stuart S. Hawley represented H. W. Meek Etate, Inc., at stockholders' meetings of Alameda Investment Company.* [Rec. p. 51.]

For the calendar year 1922, the appellant Alameda Investment Company earned a net profit of $120,701.76; Pacific Nash Motor Company sustained a loss of $228,-676.42; Hawley Investment Company sustained a loss of $36,284.29; or a let loss, assuming all corporations to be consolidated, of $144,208.94. [Stip. of Facts, Rec. p. 29.]

For the calendar year 1922, each of said three appellants without knowledge of their right to file consolidated returns, filed separate income tax returns, the appellant Hawley Investment Company and appellant Pacific Nash Motor Company paying no tax, but the appellant Alameda Investment Company paying a tax to appellee of $15,-087.72. [Complaint, Rec. pp. 5, 6; Answer, Rec. pp. 15, 16.] Thereafter, the appellants, on June 11, 1924, upon learning of their rights filed with the Commissioner of Internal Revenue consolidated income tax returns for the years 1920, 1921, and 1922, and applied to said Commissioner for leave to file said returns. [Complaint, Rec. p. 6, Answer, Rec. p. 17.]

Commissioner of Internal Revenue, granted leave to file and accepted said consolidated returns so filed on June 11, 1924, for the calendar year 1922, with respect to the appellants Hawley Investment Company and Pacific Nash Motor Company, but refused the right of affiliation to the appellant Alameda Investment Company. [Stip. of Facts, Rec. p. 30. Appellee's Exhibit #4, Rec. pp. 57, 58.]

The tax sought to be recovered was paid by the appellant Alameda Investment Company to appellee in installments during March, June, September and December of the year 1923. The complaint in this action was filed July 16, 1927. [Rec. p. 9.] The Revenue Act of 1924, including section 1014 thereof, was enacted and became effective on June 2, 1924.

Appellants filed a claim for refund of the tax so paid on June 11, 1924. [Rec. p. 6, Answer p. 17] On June

(b) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit computed as provided in subdivision (b) of section 236.

(c) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests."

(2) Section 1014 of the Revenue Act of 1924 provides as follows:

"(a) Section 3226 of the Revised Statutes, as amended, is amended to read as follows:

'Sec. 3226. No suit or proceeding shall be maintained in any court for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected until a claim for refund or credit has been duly filed with the Commissioner of Internal Revenue, according to the provisions of law in that regard, and the regulations of the Secretary of the Treasury established in pursuance thereof; *but such suit or proceeding may be maintained, whether or not such tax, penalty, or sum has been paid under protest or duress.* No such suit or proceeding shall be begun before the expiration of six months from the date of filing such claim unless the Commissioner renders a decision thereon within that

time, nor after the expiration of five years from the date of the payment of such tax, penalty, or sum, unless such suit or proceeding is begun within two years after the disallowance of the part of such claim to which such suit or proceeding relates. The Commissioner shall within 90 days after any such disallowance notify the taxpayer thereof by mail.

(b) This section shall not affect any proceeding in court instituted prior to the enactment of this act."

Errors Relied Upon.

The errors relied upon by appellants are substantially as follows:

(1) The District Court erred in holding that the "control" referred to in section 240(c) of the Revenue Act of 1921 contemplates a beneficial interest in corporate stock.

(2) The court erred in ruling that the ownership or control contemplated by section 240(c) of the Revenue Act of 1921 is not present for the calendar year 1922 so far as these appellants are concerned under the following circumstances:

(a) Where substantially all the stock of appellant Hawley Investment Company was owned or controlled by Stuart S. Hawley;

(b) Where all of the stock of appellant Pacific Nash Motor Company is owned or controlled by appellant Hawley Investment Company.

(c) Where 75 per centum of the stock of appellant Alameda Investment Company is owned by appellant Hawley Investment Company.

(d) Where the 25 per centum minority stock of appellant Alameda Investment Company was owned by H. W. Meek Estate, Inc., all of whose stock was owned by the mother-in-law, wife, sister-in-law, and brother-in-law of Stuart S. Hawley.

(e) Where Stuart S. Hawley held absolute powers of attorney from his mother-in-law and his wife, who owned two-thirds of the stock of H. W. Meek Estate, Inc., and attended to all their affairs and voted their stock in H. W. Meek Estate, Inc., in addition to being vice-president of said corporation, and voted the stock of appellant Alameda Investment Company owned by H. W. Meek Estate, Inc., all for the calendar year 1922.

(f) Where all four of the above companies had common officers, common offices, and where inter-company relations existed between the various corporations.

(3) That the District Court erred in ruling that the appellants were not affiliated during the calendar year 1922 within the meaning of section 240(c) of the Revenue Act of 1921 and entitled to have their tax liability for that year computed as a unit.

(4) That the District Court erred in ruling that appellants were not entitled to have their tax liability computed as a unit for the calendar year 1922 because of the fact that they originally filed separate income tax returns for that year, despite the fact that such separate returns were filed without knowledge of their right to file consolidated returns.

(5) That the District Court erred in ruling that payment under protest of the tax sought to be recovered

in this case is and was a condition precedent to maintenance of an action for the recovery thereof.

(6) That the District Court erred in rendering judgment for appellee as a matter of law. [Res. pp. 67 to 70.]

ARGUMENT.

I.

The Three Appellants Herein Were Affiliated During the Calendar Year 1922 Within the Meaning of Section 240 (C) of the Revenue Act of 1921.

A. The Question as to Whether or Not Two or More Corporations are Affiliated Within the Meaning of Section 240 (C) of the Revenue Act of 1921 Is a Question of Law and as Such Subject to Review by an Appellate Court.

Section 240(c) of the Revenue Act of 1921 in effect during the calendar year 1922 provides:

> "For the purpose of this section, two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by nominee or nominees substantially all of the stock of another or others; or (2) if substantially all of the stock of two or more corporations is owned or controlled by the same interests."

The finding of the District Court that the appellants herein are not affiliated must necessarily be a conclusion of law as the finding of the court is dependent upon its construction of the various statutes involved. This precise question was passed upon by the Circuit Court of Appeal for the Seventh Circuit in the recent case of the *Great Lakes Hotel Company v. Commissioner of Internal Revenue,* 30 Fed. (2d.) 1. In that case the court said:

"Petitioner accepts the findings made by the Board of Tax Appeals but excepts to the conclusions which the majority of the Board drew from the findings. This conclusion was 'on consideration of all of the facts presented, we are of the opinion that the petitioner was not affiliated with H. L. Stevens & Company or with any of its alleged affiliated corporations during 1920.' Respondent argues this is a finding of fact and inasmuch as the petitioner has not brought up the evidence, it must be accepted by this court as verity.

"While we agree with the respondent that it is immaterial whether a finding of fact appears under the heading 'conclusions of law' we are convinced that the above quotation from the Board's findings of fact and conclusions of law is *in this instance* a conclusion of law—not a finding of fact.

"The specific findings of fact which the Board made show clearly that the quoted statement was nothing more or less than the Board's conclusion drawn from such detailed facts."

B. The Control Contemplated by Section 240 (C) of the Revenue Act of 1921 Is Actual Control and Not Equitable Ownership as Stated by the District Court.

The District Court in its opinion [Rec. p. 21] said in part:

"The object of the statute is taxation in proportion to net income, equality between taxpayers, and to that end to look through the corporate entities to ascertain the real taxpayer, and if the latter substantially owns or controls several corporate enterprises, to tax him only *upon the net income he receives from all.* With this object in mind, it seems clear that *control contemplated by the statute is not mere authority but is beneficial interest.*"

It is submitted that the court failed to grasp the purpose, object and theory upon which the affiliation provisions are based. Section 240 (C) of the Revenue Act of 1921 provides that affiliation may exist when either or both of two conditions exist; ownership or *control* by one corporation of substantially all of the stock of another corporation; or ownership or *control* of substantially all of the stock of two or more corporations by the same interests.

The District Court concluded that control as used in the statute contemplated an equitable interest, in other words, *ownership*. To approve this construction is to read out of the statute altogether the word "control" as the statute specifically employs the word "owned" in addition to the word "control." The use of the words in the statute "owned or controlled" must have contemplated a situation more comprehensive than mere ownership. Had Congress intended ownership legal or equitable as the sole prerequisite to affiliation, the use of the word "control" would have been unnecessary.

That Congress in the use of the word "control" or "controlled" in section 240 (C) intended that those words should be given their commonly and ordinarily accepted meaning becomes clear when the basis for affiliated returns and the consolidation of net income for tax purposes is clearly understood. The provisions relating to consolidated returns first appeared in the Revenue Act of 1918 as section 240 thereof. The provisions of section 240 (b) of the 1918 act defining affiliation are identical with the provisions of section 240 (c) of the 1921 act.

The Senate Finance Committee in its Report No. 617, dated December 6th, 1918, in referring to the proposed provisions of section 240 of the 1918 act, said in part:

> "So far as its immediate effect is concerned, consolidation increases taxation in some cases and reduces it in other cases but *its general and permanent effect is to prevent evasion which cannot be successfully blocked in any other way.* Among affiliated corporations it frequently happens that the accepted intercompany accounting assigns too much income or invested capital to Company 'A' and not enough to Company 'B'. This may make the total tax for the corporation too much or too little. If the former, the company hastens to change its accounting methods; if the latter, there is every inducement to retain the old accounting procedure which benefits the affiliated interests even though such procedure was not originally adopted for the purpose of evading taxation. As a general rule, therefore, improper arrangements, which increase the tax will be discontinued while those which reduce the tax will be retained.
>
> "* * * While the committee is convinced that the consolidated return tends to conserve, not to reduce the revenue, the committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue but because the *principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and the government.*"

It seems too clear for argument, therefore, that the affiliation provisions are predicated upon the possibility and probability that the income of one corporation may be shifted to another in such a way that the true net income of each separate company is not reflected.

Since the prime purpose of the situation is to prevent the shifting of income, it must follow that this shifting

of income may occur regardless of by whom or how the stock is actually owned. It may occur if one individual or corporation controls the stock of two or more corporations regardless of whether such individual or corporation owns or has an equitable interest in that stock. It is too well known to require comment that corporate affairs are directed in practically all instances by those who control the stock of the corporation rather than by those who own the stock of such corporation.

It is well known that *unity of action*, which is the result of control, may follow even though ownership equitable or legal is not involved. It is only necessary to recite a few such examples:

(a) *The voting trust.* In this case there is no common ownership but absolute control and we have that *economic unit with the possibility of the shifting of income* which the senate committee specifically referred to.

(b) An express agreement between the stockholders that their stock shall be voted according to a fixed policy.

Affiliation is prescribed by the revenue acts in those cases where the circumstances negative the existence of arm's length transactions between the various corporations comprising the economic unit. This failure to deal at arm's length is certain to exist where any one individual or corporation controls the stock of two or more corporations regardless of whether such individual or corporation has any property interest legal or equitable in said stock.

The very issue herein involved has already been exhaustively presented to the United States Board of Tax Appeals, a tribunal created for the sole purpose of deal-

ing with problems arising under the various internal revenue acts. In the appeal of *Isse Koch & Company*, 1 B. T. A. 624, the Commissioner of Internal Revenue contended that the statute contemplated legal or equitable control akin to ownership. The Board in denying this contention said in part:

> "The word 'control' as defined in Funk & Wagnall's New Standard Dictionary means 'to exercise a direct, a restraining or governing influence.'
>
> "Webster defines 'control' as 'to exercise a restraining or directing influence over, to dominate, hence to hold from action, to curb, subject, overpower'.
>
> "The object sought to be accomplished by Congress in enacting section 240 of the Revenue Act of 1918 was *to tax as a business unit what really was a business unit and to prevent the component parts thereof from evading taxation by means of intercompany transactions.*
>
> "Since Congress intended to require two or more corporations where substantially all their stock is 'owned or controlled by the same interests' to file a consolidated return to prevent them from evading income tax we can see no reason for holding that the 'control' contemplated by the statute means only legal control, *for control not arising or flowing from means legally enforceable may be just as effective in evading taxation as if founded on the most formal and readily enforceable legal instrument.* There is no authority in the section of law referred to or in its context, so far as we can see, for assuming that Congress intended to use the word 'control' in other than its ordinary and accepted sense. On the other hand, we believe that a proper construction of the statute, if it is to serve the purpose for which it was intended, requires us to hold that the 'control' mentioned herein *means actual control regardless of whether or not it is based on legally enforceable means* * * *."

The Board of Tax Appeals has uniformly adhered to the definition of the word "control" as given above. See *Midland Refining Company*, 2 B. T. A. 292; *Badger Talking Machine Company*, 8 B. T. A. 455; *Highland Land Company, Ltd.*, 2 B. T. A. 100; *Stauffer Chemical Company*, 2 B. T. A. 841; *Monroe Furniture Company, Ltd., et al.*, 2 B. T. A. 743; *Tri-County Light & Power Company*, 2 B. T. A. 1165; *Brannum Lumber Company*, 2 B. T. A. 821. In these cases the Board held, *inter alia*, that confidence, unanimity, family relationship, inter-company transactions and the voting of the minority stock by proxy over a long period of years constitutes the control contemplated by the statute.

This problem has also been considered by the courts in a number of cases. In *Great Lakes Hotel Company v. Commissioner* 30 Fed. (2d.) 1, C. C. A. 7th Cir., the court said in part:

> "'Control' as used in the Revenue Act of 1918 in section 240, 40 Stat. 1081, providing that the corporations are deemed affiliated if one owns or controls substantially all the stock of the others; or if substantially all the stock of two or more is owned or controlled by the same interests, *is more comprehensive than 'owned'.*"

It thus seems clear that section 240 (c) provides for affiliation under either or both of two circumstances: (1) actual similarity of ownership; (2) actual control—that is, the operation of business under a single command regardless of equitable or legal ownership of the stock. To define control as meaning equitable ownership as did the District Court is to eliminate the word "control" from the statute and defeat the intent of Congress.

C. Substantially All the Stock of the Three Appellants Herein Was Owned or Controlled by the Same Interests Throughout the Calendar Year 1922, and Said Corporations Were, Therefore, Affiliated During Said Period Within the Meaning of Section 240 (C) of the Revenue Act of 1921.

Throughout the calendar year 1922, substantially all of the stock of appellant Pacific Nash Motor Company was owned or controlled by Appellant Hawley Investment Company. [Stip. of Fact, Rec. p. 30.] It has also been stipulated that during the calendar year 1922, Stuart S. Hawley owned or controlled substantially all of the stock of Hawley Investment Company. [Rec. p. 30.]

It is clear, therefore, that these companies were affiliated during the year 1922 within the meaning of section 240(c) of the Revenue Act of 1921, and the Commissioner of Internal Revenue has so held. [Appellee's Exhibit 4, Rec. p. 57.] Affiliation in this instance exists either through the ownership or control by one corporation of all of the stock of another, or through control of the stock of these corporations *by the same interests, namely, Stuart S. Hawley* and *Hawley Investment Company.*

During said year the Hawley Investment Company owned 75 per centum of the stock of appellant Alameda Investment Company. [Opinion of the Court, Rec. p. 21.] The remaining 25 per centum of the stock of appellant Alameda Investment Company was owned during the calendar year 1922 by H. W. Meek Estate, Inc. Stuart S. Hawley throughout the year 1922 held absolute powers of attorney from the owners of 66-2/3 per

centum of the stock of H. W. Meek Estate, Inc. The owners of the remaining 33-1/3 per centum of the stock of that corporation were the brother-in-law and sister-in-law of the said Stuart S. Hawley, neither of whom had any business experience or took any part in the affairs of the corporation. [Rec. p. 33.] Throughout the calendar year 1922 said Stuart S. Hawley handled the affairs of H. W. Meek Estate, Inc., and represented the H. W. Meek Estate, Inc., at all stockholders' meetings of Alameda Investment Company held during 1922. [Rec. p. 51.]

The problem herein involved may be briefly stated as follows:

Stuart S. Hawley clearly owned or controlled all of the stock of Hawley Investment Company, and through it all of the stock of Pacific Nash Motor Company, and through it all of the stock of the Pacific Nash Motor Company, and through it 75 per centum of the stock of Alameda Investment Company, and through H. W. Meek Estate, Inc., the remaining 25 per centum of the stock of Alameda Investment Company. Under such circumstances, are Alameda Investment Company, Hawley Investment Company, and Pacific Nash Motor Company affiliated within the purview of section 240 (c) of the Revenue Act of 1921? *It is submitted that the answer must be in the affirmative.*

It is clear that Hawley Investment Company and Stuart S. Hawley were and are "closely affiliated interests" within the meaning of section 240(c) of the Revenue Act of 1921. Hawley Investment Company owned 75 per centum of the stock of Alameda Investment Company. Stuart S.

Hawley owned or controlled substantially all of the stock of Hawley Investment Company, and, as the evidence shows, controlled the remaining 25 per centum of the stock of that company owned by H. W. Meek Estate, Inc. It thus appears that 100 per centum of the stock of the Alameda Investment Company is owned or controlled by the same interests which admittedly own or control substantially all the stock of Pacific Nash Motor Company, namely, Hawley Investment Company and Stuart S. Hawley.

In an exactly similar situation the court held that the control required by the statute existed through such closely affiliated interests: *Great Lakes Hotel Company v. Commissioner, supra.*

The evidence of control by Stuart S. Hawley of 100 per centum of the stock of Alameda Investment Company is clear and uncontroverted in any detail. It is conceded that Hawley Investment Company which owned 75 per centum of Alameda Investment Company, was owned or controlled entirely by Stuart S. Hawley, "while the remaining 25 per centum of Alameda Investment Company was owned by H. W. Meek Estate, Inc., and Stuart S. Hawley, president of appellants, manages the H. W. Meek Estate, Inc., by powers of attorney from most of its stockholders." [Opinion of the District Court, Rec. p. 21.] In other words, *actual control by Stuart S. Hawley of the three parties appellant herein is conceded by the trial court.*

It but remains to point out that there here existed that single management which was expressly contemplated by Congress in its enactment of the statute providing for

consolidated returns. Stuart S. Hawley was the president of the three appellant corporations. He was managing vice-president of H. W. Meek Estate, Inc. The president of that corporation was Mrs. Harriet W. Meek, a woman more than 65 years of age during the year 1922, all of whose affairs were handled by Stuart S. Hawley under absolute power of attorney. All of the above corporations also had a common secretary during the year 1922. During that year and prior and subsequent thereto they shared common offices; their books were kept in the same place; and their affairs were practically completely merged. In addition, they had many inter-company transactions. Hawley Investment Company was the guarantor and bailee of the loans and business ventures of Alameda Investment Company and H. W. Meek Estate, Inc.

It would indeed be difficult to find a case in which more complete control, together with ownership, was exercised over a group of business enterprises by one individual, namely, Stuart S. Hawley. *Quite clearly there existed here a complete business or economic unit under a single command,* with all the attendant possibilities of shifting of income which Congress desired to avoid.

In a word, the Hawley family owned Hawley Investment Company, Pacific Nash Motor Company, and 75 per centum of Alameda Investment Company. The H. W. Meek Estate, Inc., which owned the remaining 25 per centum of Alameda Investment Company, was owned one-half by Stuart S. Hawley's mother-in-law one-sixth by his wife, one-sixth by his sister-in-law, and one-sixth by his brother-in-law. *Stuart S. Hawley dominated all of them.*

The problems herein involved have been passed upon by the United State Board of Tax Appeals and by the courts in many similar cases.

(a) In *Ullman Manufacturing Company v. United States*, decided February 4, 1929, by the Court of Claims, reported in Reports of Commerce Clearing House, Federal Court Service for 1929, page 6577, the court held two corporations affiliated under similar circumstances, and in addition that control does not necessarily mean ownership.

(b) In *Appeal of Century Music Publishing Company v. Commissioner*, 12 B. T. A. 647, it appeared that three companies were dominated by one individual. The Board held the three companies affiliated, saying: "In all the thirty years existence of these three corporations, they have been completely dominated, managed, and financed by Leo Feist. * * * In all these thirty years there has been no diverse or antagonistic interests. The business was conducted as an economic and business unit, and the interests of all were exactly the same."

(c) In the *Appeal of Tri-County Light and Power Company v. Commissioner*, 2 B. T. A. 1165, the Board of Tax Appeals held two corporations affiliated where the husband voted all the stock owned by various members of the family. The situation in that case is strikingly similar to that involved in the instant appeal.

(d) In the *Appeal of Brannum Lumber Company v. Commissioner*, 2 B. T. A. 821, the Board of Tax Appeals held two corporations to be affiliated where a son owned a minority of the stock in one company and his parents owned the majority of the stock in that company and all of the stock in the other company, the son being the manager of both corporations.

It is submitted that the facts in this case clearly demonstrate the existence of an actual, positive, and

dominating control by Stuart S. Hawley through himself or through closely affiliated interests, including Hawley Investment Company, and H. W. Meek Estate, Inc., of substantially all of the stock of the three appellant corporations herein involved. It must follow, therefore, that these three companies were affiliated during the calendar year 1922, and as such entitled to file affiliated returns.

II.

The Fact That Appellants Originally Filed Separate Income Tax Returns for the Calendar Year 1922 Without Knowledge of the Fact That a Consolidated Return Was Proper Does Not Destroy their Right to Have Their Tax Liability Determined as a Consolidated Group.

In this connection the District Court stated in its opinion:

> "In 1922 the corporations plaintiff elected to make separate returns and have no right to recover taxes paid on that basis. It may be that in 1924 the Commissioner could have permitted an amendment to consolidate the 1922 returns. If so the power is discretionary only." [Rec. p. 22.]

Section 240(a) of the Revenue Act of 1921 provides in part as follows:

> "That corporations which are affiliated within the meaning of this section may for any taxable year beginning on or after January 1, 1922, make separate returns, or under regulations prescribed by the Commissioner with the approval of the secretary make a consolidated return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. If return is made on either of such basis all

returns thereafter made shall be upon the same basis unless permission to change is granted by the Commissioner."

A. THE APPELLANTS CANNOT BE SAID TO HAVE MADE A BINDING ELECTION WHEN THEY HAD NO KNOWLEDGE OF THEIR RIGHT TO FILE CONSOLIDATED RETURNS FOR THE CALENDAR YEAR 1922.

The original separate returns for the year 1922 were filed by appellants "without knowledge that they were entitled to file a consolidated return of income." [Complaint Rec. p. 5.] The appellee, by failure to refer in any way to this positive allegation in his answer must be considered as having admitted the truth thereof. Section 462 of the Code of Civil Procedure of California provides:

> "Every material allegation of the complaint not controverted by the answer must for the purpose of the answer be taken as true. * * *"

It is too well settled to require citation of authorities that the Federal Courts follow the rules of practice, procedure, and pleading adopted by the states.

An election to be binding implies a knowledge of one's rights. The rule is thus stated in 20 Corpus Juris 19, 35:

> "It may be stated as a general rule that any decisive act of a petitioner *with knowledge of his rights*, and of the facts indicating intent to pursue one remedy rather than the other, determines his election in case of conflicting and inconsistent remedies. To the proper application of this rule at least three things are essential: (1) There must be in fact two or more co-existing remedies between which the party has the right to elect; (2) The remedies thus open to him must be inconsistent; (3) He must, by actually bringing his action or by some other decisive act, with knowledge of the facts, indicate his choice between these two inconsistent remedies.

"A binding election, however, cannot be made where the party is in ignorance of the remedies.

"An election between two *remedies necessarily implies knowledge that there are two remedies,* * * * and an election made by a party under a mistake of facts, or a misconception of his rights is not binding in equity, and this is true whether the mistake is one of law or one of fact. * * *" *(Standard Oil Co. v. Hawkins,* 74 Fed. 395. *Graybill v. Corlett,* 60 Colo. 551; 154 Pac. 730.)

B. THE ELECTION PROVIDED BY SECTION 240(a) OF THE REVENUE ACT OF 1921, ASSUMING ONE IS SO PRESCRIBED, APPLIES ONLY TO YEARS SUBSEQUENT TO 1922, AND DOES NOT PROVIDE THAT RETURNS ON A BASIS DIFFERENT FROM THE ORIGINAL RETURNS MAY NOT BE FILED FOR THE YEAR 1922.

Section 240(a) in this connection states:

"If return is made on either of such bases (separate or consolidated) *all returns thereafter made shall be upon the same basis* unless permission to change the basis is granted by the Commissioner."

It was clearly the intent of Congress to require the taxpayer or taxpayers to decide for the calendar year 1922 whether or not they desired to file separate or consolidated returns, and, when the decision had been made with knowledge of the facts, to file the same type of return for the year 1923 and subsequent years. The reason for this requirement is obvious. By filing separate returns for one year and consolidated returns for the ensuing year, it would be possible to so shift income that the prime purpose for consolidated returns would be forever lost.

Such a situation, however, does not exist where the taxpayer desires only to change from the separate to the

consolidated basis for the year 1922 and does not intend to change its basis for 1923 and subsequent years. To so construe the statute clearly carries out the intent of Congress. A final decision must be made with regard to the year 1922. The statute does not say that the basis for 1922 shall not be changed but only that the basis adopted for 1922 must be followed in subsequent years. Subsequent returns must contemplate returns for subsequent years and not amended returns for the same year.

In fact, any other construction of the statute in reality defeats the intent of Congress, which was to give the taxpayer its option for the year 1922, and require the taxpayer to be consistent during all ensuing years. In effect, Congress intended that if any benefits were to be derived from consolidated returns for the calender year 1922, that the taxpayer should assume any burdens incident thereto in ensuing years. It was quite clearly intended, however, that the taxpayer should have the choice as to whether or not it would assume this risk. *The construction of the lower court deprives the taxpayer forever of the opportunity to make this choice.*

C. Assuming without conceding that the permission of the Commissioner must be obtained in order for the affiliated returns to be acceptable, the Commissioner in this case has given permission for appellants to change their basis provided there exists the ownership or control contemplated by section 240(c) of the Revenue Act of 1921.

On June 11, 1924, when appellants learned of their right to file consolidated returns for 1922, such returns were filed, and thereafter were duly audited by the Com-

missioner. On October 14, 1925, prior to the institution of this suit the Commissioner, through his duly authorized agent, addressed the appellant, Hawley Investment Company, with reference to the amended consolidated returns filed on June 11, 1924, not only for the year 1922 but also for the years 1920 and 1921. In this letter the Commissioner states in part as follows:

> "During the taxable years 1921 and 1922, Hawley Investment Company and Pacific Nash Motor Company were affiliated and should have filed a consolidated income and profits tax return for the taxable year 1921. Alameda Investment Company was not affiliated during these years and should have filed a separate return for each of these years. The consolidated income tax return filed by your corporation for the taxable year 1922 should, therefore, have included only Pacific Nash Motor Company in addition to your (Hawley Investment Company) corporation.
>
> "In the event that the returns indicated above should be needed in the audit of the case, you will be notified by this office.
>
> "This ruling *supersedes all previous rulings of the Bureau of Internal Revenue covering affiliation of these companies for the years 1920, 1921 and 1922.*"
>
> [Appellee's Exhibit 4, Rec. p. 58.]

The above letter can only be construed as an acceptance of the affiliated return filed June 11, 1924 for the year 1922, insofar as the Commissioner deemed that said companies fell within the provisions of section 240(c). The Commissioner's letter constitutes permission to all companies *actually* affiliated to file affiliated returns for the year 1922, as the returns accepted by the Commissioner

for Hawley Investment Company and Pacific Nash Motor Company were affiliated returns.

By the same token, it must follow that the Commissioner, if he gives permission to any members of an affiliated group to file affiliated returns, must be deemed to have given such permission to all of the members of that group. *To hold otherwise would vest the Commissioner with the arbitrary power to affiliate those companies with the losses as was the case with Hawley Investment Company and Pacific Nash Motor Company, and require a separate return for the company or companies with the profits.*

The Commissioner himself in the rulings issued by his Department has recognized and followed these propositions. Income Tax Ruling No. 2084, reported in Cumulative Bulletin III-2, p. 356, states the rule as follows:

> "An affiliation ruling letter from the Income Tax Unit advising the taxpayer that various corporations are to be included in a consolidated return *is held to be a special permission within the meaning of the 1921 Act.* Special Permission means permission given in a particular case. A ruling requiring that consolidated returns be filed *or holding that certain corporations are affiliated* and that a consolidated return may be filed *is permission to file such a return within the meaning of the statute.*"

The Solicitor of Internal Revenue, attorney for the Commissioner of Internal Revenue, has uniformly followed the construction herein contended for. In Solicitor's Memorandum No. 2683, reported in Cumulative Bulletin IV-1, p. 238, the Solicitor stated:

"Can the agent of a group of organizations which are affiliated within the meaning of section 240(b) of the Revenue Act of 1921 elect to file a consolidated return for part of the group and individual returns for the balance, or must the entire group be either consolidated or file separate returns? * * * The language of section 240(a) is specific. * * * This language can mean but one thing: that the group as a whole may render individual corporate returns or that the group as a whole may render a consolidated return. This office is therefore of the opinion that where a group of corporations are affiliated within the meaning of section 240(c) of the Revenue Act of 1921, they must for any taxable year beginning on or after January 1, 1922, either elect to file one consolidated return for the entire group or file individual returns for each corporation.

"Where this election is made it will be binding on all future years unless permission is secured from the Commissioner to change the basis before the due date of filing of the return."

If the provision above outlined is binding on the taxpayer then it must be equally binding on the Commissioner.

The conclusion is inescapable that the Commissioner, by his letter of October 14, 1925, intended to grant special permission and did grant special permission to file a consolidated return to all companies falling within the consolidated group. It is only necessary, therefore, in this case to show that Alameda Investment Company is affiliated with the other two companies as defined by section 240(c) of the Revenue Act of 1921.

III.

In This Case Payment Under Protest Is Not a Condition Precedent to the Recovery of a Tax Erroneously Paid.

A. Regardless of the enactment of section 1014 of the Revenue Act of 1924, payment under protest is not a pre-requisite for the recovery of an internal revenue tax erroneously paid.

There is no provision in any income tax act which requires that the tax be paid under protest as a condition precedent to its recovery. Section 252 of the Revenue Act of 1921 provides in part as follows:

> "If upon examination of any return of income made pursuant to this act * * *, it appears that an amount of income, war profits, or excess profits tax has been paid in excess of that properly due, then notwithstanding the provisions of section 3228 of the revised statutes, the amount of the excess shall be credited against any income, war profits, or excess profits, or installments thereof, then due from the taxpayer under any other return, and *any balance of such excess shall be immediately refunded to the taxpayer.*"

In *Greenport Basin & Construction Company v. United States*, 269 Fed. 58, the District Court for the Eastern Division of New York held that payment under protest was not a condition precedent to recovery of tax paid under the Revenue Act of 1918, and cited in support of its decision the provisions of section 252 of the Revenue Act of 1918, which are exactly similar to those of the same numbered section of the 1921 Act quoted above.

While the suit in question was against the United States the language is equally applicable to a suit against a collector.

The District Court for the District of Connecticut reached the same conclusion in the case of *Capewell Horse Nail Company v. Walsh*, 1 Fed. (2d) 818. In that case the court said in part:

> "It appears that under the specific provisions of the Act, the plaintiff is entitled to a refund whenever it appears on examination of the return that the amount of tax paid is in excess of that properly due. * * * Under the circumstances, the money is properly recoverable when paid, wholly irrespective of the existence or non-existence of protest at the time of payment. The Act of Congress does not provide for the making of any protest as a condition precedent to the right of recovery. * * *."

See, also,

United States v. Hoslef, 237 U. S. 1.

B. Assuming But Not Conceding That Prior to June 2, 1924, Payment Under Protest Was a Prerequisite to the Recovery of a Tax, the Provisions of Section 1014 of the Revenue Act of 1924 Eliminated This Requirement In All Cases Similar to the One at Bar Where Suit was Instituted After the Effective Date of That Act.

Section 1014 of the Revenue Act of 1924, enacted June 2, 1924, provides in part as follows:

> (a) " * * * Such suit or proceeding may be maintained whether or not such tax, penalty, or sum has been paid under protest or duress.
>
> (b) This section *shall not affect any proceeding in court instituted prior to the enactment of this act.*"

There is no provision in the statute that this provision of law shall apply only in cases where the tax in question was paid after June 2, 1924.

The legislative history of section 1014(a) of the 1924 Revenue Act is pertinent. The report of the Committee on Ways and Means, dated February 11, 1924, in commenting on the proposed section 1014(a) of the 1924 Act, said:

> "The provisions of section 1318 of the existing law have been amended to provide that after the enactment of the bill it shall not be a condition precedent to the maintenance of a suit to recover taxes, sums or penalties paid, that such amounts shall have been paid under protest or duress. *The fact that protest was made has little bearing on the question of whether the tax was properly or erroneously assessed.* The making of such a protest becomes a formality so far as well advised taxpayers are concerned and the requirements of it may operate to deny full credit to a taxpayer who is not well informed."

The above language indicates clearly that Congress was not interested in the technical requirements of a protest but was interested only in whether or not the taxes paid were in fact excessive, illegal, or erroneous. The language also clearly shows that the amendment was intended to apply to taxes already paid, the only limitation being, as is set forth in the statute itself, *that the provisions of the statute shall not affect suits already instituted. The suit in this case was filed July 16, 1927.* It would seem entirely clear, therefore, that it is immaterial that the tax herein sued for was not paid under protest.

The District Court in its opinion in this case refers to the case of *Smietanka v. Indiana Steel Company,* 257 U. S. 1, as requiring protest. It is submitted, however, that the only principle established by that case is that a taxpayer may not sue the successor in office of a col-

lector of internal revenue for a tax paid the defendant's predecessor.

The District Court stressed the proposition that the appellee might be personally liable for this judgment and the appellee had acted without fault. This technical argument is not persuasive. It is too well known to require comment that in all cases where judgments are entered against collectors of internal revenue, certificates of probable cause are issued by the court and the amount of the judgment is promptly paid out of the treasury of the United States. The situation is exactly the same as if the judgment were against the United States. Section 1315, Revenue Act of 1921. To rely upon an apparent technical individual liability of a collector is to invoke time-worn and out-of-date principles and to defeat justice in order to carry out an admittedly useless formality.

A number of courts have already passed upon the express problem herein involved. In *Warner v. Walsh,* 24 Fed. (2d) 449 the facts were identical with those involved herein. The court in holding that no protest was necessary where suit was instituted subsequent to June 2, 1924, said:

> "I am of the opinion that this language (section 1014(a) of the 1924 Act) changes the rule heretofore prevailing, and an action may now be maintained against a collector for the recovery of income tax erroneously paid regardless of protest."

See also *Weir v. McGrath* decided by the United States District Court for the Southern District of Ohio, May 21, 1928, and reported in American Federal Tax Reports, volume 6, page 8005, otherwise unreported. In that case the court said:

"But it is objected that suits against collectors of internal revenue are personal and that payments made prior to the amendment of June 2, 1924, without protest created a vested right to a then existing defense on the part of the collector which could not thereafter be defeated by legislation.

"* * * But we do not think that such actions are to be considered as so far personal to the collector of internal revenue, individually, that Congress is prevented from providing any reasonable system, by suit against the collector or otherwise, for re-payment to the taxpayer of taxes illegally or erroneously collected even though such taxes were paid without formal protest. * * * *The amendment of 1924 obviously had reference and application to payments already made and suits founded thereon as well as to payments to be made.* * * .*"

It is submitted, therefore, that payment under protest not a prerequisite to the maintenance of this suit.

Conclusion.

I.

The three appellants were affiliated during the calendar year 1922 within the meaning of section 240(c) of the Revenue Act of 1921.

(a) Hawley Investment Company owned all of the stock of Pacific Nash Motor Company.

(b) Hawley Investment Company owned 75 per centum of the stock of Alameda Investment Company.

(c) The remaining 25 per centum of the stock of Alameda Investment Company was owned by H. W. Meek Estate, Inc.

(d) The stock of Alameda Investment Company owned by H. W. Meek Estate, Inc. was controlled and voted by Stuart S. Hawley.

(e) Stuart S. Hawley owned or controlled all the stock of Hawley Investment Company.

(f) "Control" as used in section 240(c) 1921 Revenue Act means actual control and not equitable ownership.

(g) The three appellants were affiliated during the calendar year 1922 because substantially all their stock was owned or controlled by the same interests.

II.

The fact that the appellants originally filed separate income tax returns without knowledge of their legal rights is immaterial.

(a) No person can make a binding election without full knowledge of his rights in the premises.

(b) The election provided by section 240(a) of the Revenue Act of 1921 applies only to years subsequent to 1922.

(c) The Commissioner of Internal Revenue, as a matter of fact, gave special permission to all companies *properly* within the consolidated group to file consolidated returns for the year 1922.

III.

It is immaterial that the tax herein sought to be recovered was not paid under protest.

(a) Protest is not a prerequisite to the maintenance of a suit for the recovery of a tax illegally collected.

(b) Even if protest were necessary this requirement was specifically eliminated by section 1014 of the Revenue Act of 1924.

It is respectfully submitted that the judgment of the District Court should be reversed.

Respectfully submitted,

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